OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
December 17, 1998

CC:DOM:FS:CORP
Number: **199913003**
Release Date: 4/2/1999

UILC: 1502.90-01
404.15-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE DISTRICT COUNSEL

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated September 15, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

A=
T=
S=
D1=
D2=
D3=
Y1=
Y2=
$a=
$b=
$c=
$d=
$e=

ISSUE:

When a member of one consolidated group is acquired by a different consolidated group under the specific facts of this case, and the acquired corporation makes a "grace period" contribution to its defined benefit plan, how should the grace period contribution be allocated between the two consolidated return groups? That is, may the acquiring group deduct the entire grace period contribution, as opposed to only deducting the portion of the contribution allocable to the period during which the acquired corporation was a member of the acquiring corporation's consolidated group?

CONCLUSION:

We conclude that Treas. Reg. § 1.1502-76(b)(4)(ii)[1], which authorizes and requires a pro rata allocation methodology under specified circumstances, sets forth the proper allocation method for apportioning the grace period contribution deduction. Thus, the acquiring group may deduct only that portion of the contribution allocable to the period during which the acquired corporation was a member of the acquiring corporation's consolidated group.

FACTS:

Under our understanding of the facts (as provided to your office by the Examination Division), A bought all the stock of T from S, an unrelated corporation, on D1 (the 141st day of the its taxable year). T had filed its income tax returns as a member of the S consolidated group. After its acquisition by A, T became a member of the A consolidated group. A and T are accrual basis, calendar year taxpayers.

T had a qualified, defined benefit pension plan. For Y1, T initially contributed $a in respect of the plan. A prorated the deduction, and deducted 224/365 of this amount on its Y1 consolidated return.

In Y2, A's actuary changed the method of valuing plan assets such that an additional contribution could be made to the plan. The actuary determined that an additional deductible contribution of $b could be made to the plan for Y1, and a

[1]In this memorandum, all references to Treas. Reg. § 1.1502-76(b)(4) relate to the version of the regulation in existence prior to January 1, 1995.

contribution in that amount was made on D2.[2] You have asked us whether A is entitled to deduct the entire amount of the $b payment.

A has informed the Examination Division that T made payments to its pension plan quarterly and entered the contributions on its books quarterly. Thus, the contribution at issue was entered in the books after T became a member of the A consolidated group. A did not prorate the grace period contribution on its books, but recorded the entire payment on T's books.

A has not proposed that it take the entire $a deduction, just the entire amount of the additional grace period payment. A's position is that A, not S, made the decision to change the plan's asset valuation and that "A money" was used to fund the grace period payment. These two facts lead A to conclude that it does not have to prorate the grace period deduction.

LAW AND ANALYSIS

Section 404(a) generally provides that if contributions are paid by an employer to or under a stock bonus, pension, profit sharing or annuity plan, or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under Chapter 1; but if they are otherwise deductible, they shall be deductible under section 404(a).

The general rule of section 404(a) provides that deductions under that section are generally allowable only for the year in which the contribution or compensation is paid, regardless of the fact that the taxpayer may make his returns on the accrual method of accounting, exceptions are made. Section 404(a)(6) provides, in pertinent part, that a taxpayer shall be deemed to have made a payment on the last day of the preceding taxable year if the payment is on account of such taxable year, and is made not later than the time prescribed by law for filing the return for such taxable year (including extensions). The period of time after the close of the preceding taxable year, and not later than the time prescribed for filing the return for such taxable year, is referred to as the "grace period."

Under Treas. Reg. § 1.1502-76(b)(1), the consolidated return of an affiliated group must include the income of the common parent for its entire tax year and the

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[2] Under section 404(a)(6), a contribution is deemed made on the last day of the preceding taxable year if it is made on account of that taxable year and is made by the due date of the return for the preceding taxable year, including extensions. A's Y1 return was due on D3. Therefore the D2 contribution was made within the "grace period."

income of each subsidiary for the portion of such tax year during which the subsidiary is a member. Treas. Reg. § 1.1502-76(b)(2) provides that if the consolidated return of a group properly includes the income of a corporation for only a portion of its tax year (because, for example, that member either became or ceased to be a member of a consolidated group during such consolidated year) then that corporation's income must be included in a different separate return (or if that corporation was or became a member of another consolidated group for the portion of the year in question, then in the other group's consolidated return).[3]

Treas. Reg. § 1.1502-76(b)(4)(i) provides that if the taxable income of a member is to be included in a consolidated return for only a portion of its tax year (without regard to a change of its year) and in another consolidated group return for the remainder of the year, then the portion of income to be allocated between each consolidated return shall be determined on the basis of the departing (or entering) member's permanent records for the year, including work papers. However, under Treas. Reg. § 1.1502-76(b)(4)(ii), if the portion of an item of income or deduction cannot be clearly determined from the permanent records, then the portion of such item to be included in each return is the amount of the item for the full taxable year multiplied by a fraction, the numerator of which is the number of days for which the member's income is to be included in the return and the denominator of which is the total number of days in the year.

Whether a taxpayer uses the cash receipts and disbursements method of accounting or the accrual method of accounting, the items of income and deductions that must be allocated to each short year must be based upon the allocation method described in Treas. Reg. § 1.1502-76(b)(4)(i), if such information is shown on the taxpayer's permanent books and records. If not, the items of income and deductions are apportioned between the two short taxable years in proportion to the number of days in each short year.

Thus, the allocation of T's income is based on a three step process. First, T's taxable income for the year must be determined as if it had not changed consolidated groups. Then, to the extent the portion of the items comprising T's income and deductions to be reported on each consolidated return can be clearly determined from its permanent financial records, the required allocation will be accomplished in accordance with Treas. Reg. § 1.1502-76(b)(4)(i). Finally, to the extent the portion of items to be reported on each consolidated return cannot be

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[3] In our case, T became a member of the A consolidated return group after it left the S consolidated return group. Accordingly, in discussing Treas. Reg. § 1.1502-76(b)(2), we will always assume that the parenthetical phrase of that section applies (e.g., "or, if that corporation is a member of another consolidated group ... , then in the other group's consolidated return").

clearly determined from T's permanent financial records, the allocation will be based on the daily allocation methodology set forth in Treas. Reg. § 1.1502-76(b)(4)(ii). In making the allocation calculation, a review of Service rulings and cases is instructive.

As noted by the incoming memorandum, TAM 85-14-002 (December 17, 1984) addresses a situation similar to the one under discussion. The issue under consideration was whether pension contribution deductions should be allocated on a pro rata basis between the two affiliated groups with which the subsidiary filed consolidated returns during a single taxable year. In that TAM, the corporations were all calendar year, accrual basis taxpayers. The target corporation (Corp B) was a wholly owned subsidiary of the selling corporation (Corp C) until the acquiring corporation (Corp A) bought all of Corp B's stock. Corp B had been included in the consolidated return of Corp C until it became a member of Corp A's consolidated group.

In the TAM, Corp B had two qualified pension plans. It contributed money to the plans during the portion of the year that Corp A owned Corp B's stock. Corp B made a grace period contribution to its plans, attributable to the year of Corp B's acquisition. There is no mention in the TAM of how Corp B booked the regular or grace period contributions. On the consolidated return filed by Corp A, the entire contribution made or attributable to Corp B's acquisition year was deducted. Corp A's position was that section 404(a) places all taxpayers on a cash basis with respect to payments to a qualified profit-sharing trust. Thus, the acquiring group argued that the entire contribution should be deducted on its consolidated return because the entire amount was paid by the subsidiary after it was acquired by Corp A. The TAM rejected Corp A's contention. Rather, the TAM concluded that the entire contribution should be allocated between Corp A and Corp C based on the number of days each owned the stock of Corp B.

The TAM countered Corp A's section 404(a) argument with respect to the contributions by noting that section 404(a)(6) requires that a payment be made "on account of" a taxable year in order to be deductible. The TAM concluded that while Corp B made a contribution to its plan during the year of Corp B's acquisition, or attributable to that portion of the year that Corp A owned Corp B, only a certain percentage of that payment was "on account of" the portion of the year that Corp A owned the stock of Corp B. The TAM concludes that only that percentage should have been deductible on Corp A's return.[4]

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[4] [redacted]

You have asked us to consider whether the rationale of the TAM controls the outcome of your case. Your incoming memorandum notes that in the present context, unlike in the TAM, we have information on how the grace period contribution was recorded in the books and records: it was booked when paid, consistent with T's method of recording the contributions. Since Treas. Reg. § 1.1502-76(b)(4)(i) says that the income to be reported shall be determined based on the corporation's permanent records, you believe allowing A to deduct the full amount of the grace period contribution appears to be appropriate here. We do not agree. An overview of cases and Service rulings, as well as a brief discussion as to the nature of the payments in question will be helpful in understanding our conclusion.

In Petroleum Heat and Power, 405 F.2d 1300 (Ct. Cl. 1969), the taxpayer's principal business was the sale of fuel oil. The taxpayer entered into contracts with most of its buyers, under which the taxpayer was to service its customers' oil burners during the contract year. The contracts ran from July to June, coinciding with the taxpayer's fiscal year. Although the taxpayer billed and received payment for the full amount of the contract at the time of execution, receipts of the contract price were put into a deferred income account. Income was deemed earned on the basis of 1/12 of the contract price for each of the 12 months of the contract period. As expenses were incurred in the servicing of oil burners, they were charged to the deferred income account, thereby reducing the account by a like amount. On January 10, 1963, the shareholders sold all of the taxpayer's stock. The question arose as to the proper method for allocating the funds in the deferred income account.

The Service argued that the income should be included in the return for the period in which it was received (i.e., the earlier short period return). The taxpayer argued, and the Court of Claims agreed, that the regulations then in effect (Treas. Reg. § 1.1502-32A, the predecessor to Treas. Reg. § 1.1502- 76(b)(4)) required the Service to accept the taxpayer's statement of income as reflected in its books and records. Since the taxpayer's books and records adequately reflected the income accruing throughout the twelve month period, the regulation obligated the taxpayer to file its returns consistent with such records. In Petroleum Heat and Power, the court followed the books and records of the corporation because it believed that such records clearly reflected the portion of the income to be included in each month, even though the income was actually received at an earlier time.

Petroleum Heat and Power stands for the proposition that when a taxpayer consistently accrues income and expenses on its books and records in a manner that *clearly reflects such items*, and then uses such books and records to comply with Treas. Reg. § 1.1502-76(b)(4)(i), such allocation method will be respected. If the books and records fail to clearly reflect the portion of the item of income or deduction to be allocated, then the ratable allocation method of Treas. Reg. § 1.1502-76(b)(4)(ii) should control. But see Southern California Savings & Loan Association v. Commissioner, 95 T.C. 35 (1990), (the court failed to accrue interest income ratably, despite the fact that the taxpayer's books and records did not clearly reflect the portion of the interest deduction to be allocated to either short period return, since interest payments, like pension fund contributions, are not items capable of any treatment other than ratable allocation).

The Service followed the Petroleum Heat and Power line of reasoning in a ruling request addressing vacation pay accruals. In LTR 82-14-020 (December 31, 1981), the taxpayer had followed a practice of expensing vacation pay in the year the vacation became vested. An eligible employee became vested on December 28th, in the year preceding the year the employee would receive the vacation. The taxpayer spread the vacation pay expense throughout the year in which the vesting occurred.

Prior to the close of the taxable year in issue, the taxpayer was acquired by a consolidated group. Thus, it was required to file a separate return for the short period of January 1, 1978, through August 29, 1978. The taxpayer claimed as a deduction the accrued amount of vacation pay expense on the short period return even though the vacation was not vested when the short period closed on August 29, 1978.

The Service determined that the vacation pay expense accrued by the taxpayer from January 1, 1978, to August 29, 1978, was properly deducted by the taxpayer on its short period return under Treas. Reg. § 1.1502-76(b)(4)(i). The Service's decision was based on its factual determination that the taxpayer had consistently

accrued the vacation pay expense on its books and records in each pay period, based upon employment levels during the period and the length of service employees worked during the particular period. The Service specifically held that the contingent nature of the liability did not in itself prevent a deduction under section 162(a) on the short period return (as is generally the rule under the all events test of Treas. Reg. § 1.461-1(a)(2)). The Service concluded that disallowing the taxpayer a deduction for the accrued amount would result in a distortion of income and expense in both short tax years.

The common thread running through all these situations is that when a specific item of income or deduction can be adequately and clearly determined to be properly included in a specific short period income tax return, based on the taxpayer's permanent records, it must be so allocated under Treas. Reg. § 1.1502-76(b)(4)(i). Overall, the courts and the Service have given much deference to a taxpayer's method of accounting in its permanent records, provided that those records clearly and consistently reflect income and expenses. However, when the period to which the item of income or deduction is attributable cannot be clearly determined, then the pro rata allocation method of Treas. Reg. § 1.1502-76(b)(4)(ii) must be utilized. See, PLR 82-30-041 (April 27, 1982); GCM 39,292, (April 30, 1984), for examples in which the Service based its Treas. Reg. § 1.1502-76(b)(4)(ii) allocation on the rationale that information from the permanent books and records was insufficient to justify a Treas. Reg. § 1.1502-76(b)(4)(i) allocation.

In order to determine whether the A consolidated group is entitled to deduct the full amount of the grace period payment, it is important to assess the specific facts of this case, taking into consideration the general nature of pension plan payments. TAM 85-14-002 does not provide us with a clear position in this case. Although here we know that T paid and booked contributions to its pension fund on a quarterly basis, when payments actually occurred, and that the grace period contribution was paid and booked after A acquired T’s stock, we do not believe these facts determine the portion of the pension payments, including the grace period contribution, to be included in either consolidated group’s short period return. The real issue is whether the booking of the quarterly contributions, and the grace period contribution, to the pension fund clearly reflects which portion of the payment is to be included in each such return as required by Treas. Reg. § 1.1502-76(b)(4)(ii). If not, then the payments must be ratably spread throughout the entire year. Although one could argue that T’s books and records sufficiently identify the grace period payment as being properly included solely in A’s consolidated group return, in that the payment and booking of the contribution occurred after T’s stock was acquired by A, we do not believe this is the correct result, given the nature of defined benefit plan payment computations in general, and the specific factual context of this case.

Section 404(a)(1), as applicable to defined benefit plans, relies on an actuarial computation in order to determine the maximum or minimum allowable annual contribution to a pension plan. Actuarial computations treat a given tax year as a single unit. Quarterly payments are merely estimates of the demographics of the employer's workforce. They do not reflect an actual annuity computation of the maximum or minimum allowable annual contribution. Until the annual annuity analysis is made, the true amount of the allowable contribution is unknown. The calculation of the annual allowable payment is based on facts existing throughout the entire taxable year. An individual payment cannot reasonably be allocated to any specific period throughout the year, simply because the payment is made at a given time. This would be inconsistent with the nature of actuarial methodology. Because of the nature of defined benefit plan computations, any given year is essentially indivisible for actuarial purposes. Thus, a clear determination cannot be made from A's permanent books and records regarding its allocable share of the defined benefit plan contribution deduction.

In addition to the foregoing, we note that A's actuary's determination that an additional contribution could be made to the plan was presumably based on the amount of contributions previously made to the plan throughout the taxable year in issue, as well as on a computation of the value of the assets in the plan, for the entire taxable year. That is, A's actuary revised certain estimates and assumptions made by S's actuary, which estimates T had relied upon in making its quarterly plan contributions. This revision permitted the A group to make a larger contribution to T's plan than had been originally assumed at the time A purchased T's stock. Thus, the grace period payment merely reflects that as a result of A's actuarial's modifications to certain assumptions made by S's actuarial, T's maximum allowable pension fund contributions were greater than when different, yet nonetheless reasonable, assumptions were made by S's actuary. As such, the payments should be treated in conformity with the treatment accorded to the four original quarterly payments. This treatment is also consistent with the fact that under section 404(a)(6), grace period contributions are treated as having been made on the last day of the employer's tax year, if made "on account" of such year.

Additionally, the grace period contribution was not solely related to the time A owned T's stock. Although the entire payment was made and entered on the books of T during the time it was owned by A, as noted in TAM 85-14-002, only a portion of the payment (224/365th) was, under section 404(a)(6), "on account" of the portion of the year that T was owned by A. As such, A should not be entitled to deduct the entire contribution.

The above recommendation is influenced by our assumption that the deductions in question generally arise fairly evenly over the course of the tax year, absent some unusual circumstance. In light of this, we believe that the pro rata allocation method is appropriate here. (Note, that were the taxpayer to come forward with

adequate books and records to sustain allocating a deduction to a specific date, then the allocation method of Treas. Reg. § 1.1502-76(b)(4)(i) would need to be applied.)

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

Please let us know if you have any further questions.

DEBORAH A. BUTLER
Assistant Chief Counsel

By: _____
STEVEN J. HANKIN
Acting Branch Chief